

Internal Revenue Service

SIN 419A.00-00  
Department of the Treasury

Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to: OP:E:EO:T:4

Date: JAN 20 1999

Dear Sir or Madam:

This letter is in response to the request for a ruling submitted by your authorized representative on your behalf in a letter dated March 2, 1998. The conference of right on the issues raised in this ruling request was held on July 28, 1998.

You are exempt from tax under section 501(c)(9) of the Internal Revenue Code. You fund an employee welfare plan. Funds are contributed by participating employers and employees, and are held for exclusive purpose of administering the employee welfare benefit plan for the benefit of participating employees and their beneficiaries. You provide comprehensive medical benefits to active contractor members and their employees. The plan is fully insured. You pay premiums to insurance carriers who provide medical benefits to the participants. You are not operated under a collective bargaining agreement.

Each participating employer may choose to cover its hourly employees only, or all of its employees. Each employer may choose to pay hourly or monthly contributions for hourly employees. Under either arrangement, employees must work a specified minimum number of hours in order to be eligible for benefits. Hours worked in excess of the required minimum can be "banked" to cover periods in which the employee does not work the specific number of hours. Under the various payment methods available to employers, contributions may be made to you which cover premiums to be paid in future months.

You propose to set aside in separate bank account investment income to pay future insurance premiums and trust expenses resulting from employees who have earned future benefits by working in excess of the minimum number of hours and employees who are entitled to future benefits due to the terms of the payment plan selected by their employer.

You have requested a ruling that your taxable income does not include investment income earned on the amounts thus set aside on the basis that your

21

199015059

obligation to pay insurance premiums on behalf of employees with "banked" hours constitutes "claims incurred but unpaid."

Section 512(a)(3)(A) of the Code provides, in relevant part, that with respect to an organization described in section 501(c)(9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income).

Section 512(a)(3)(B) of the Code provides, in relevant part, that exempt function income includes income which is set aside to provide for the payment of life, sick, accident, or other benefits.

Section 512(a)(3)(E)(i) of the Code provides, in relevant part, that a set-aside may be taken into account only to the extent that such set-aside does not result in an amount of assets set aside for the payment of benefits in excess of the account limit determined under section 419A (without regard to subsection (f)(6) thereof) for the taxable year.

Section 419A(c)(1) of the Code provides that the account limit for any qualified asset account is the amount reasonably and actuarially necessary to fund claims incurred but unpaid and administrative costs with respect to such claims.

The legislative history provides a definition of "claims incurred but unpaid:"

*Claims are incurred only when an event entitling the employee to benefits, such as a medical expense, a separation, a disability, or a death actually occurs.* H. Conf. Rept. No. 98-861, at 1156.

Section 419A(f)(5) of the Code provides that no account limits shall apply in the case of any qualified asset account under a collective bargaining agreement.

In *Parker-Hannifin Corporation v. Commissioner*, No. 96-2580 (March 23, 1998), the Sixth Circuit Court of Appeals sustained the decision of the Tax Court disallowing a deduction taken pursuant to sections 162 and 419 of the Code for a contribution for medical benefits for union employees of \$3,210,000 to a welfare fund made during the year ending June 30, 1987, purportedly to cover claims incurred but unpaid as of that date. The contribution represented amounts that Parker-Hannifin estimated would be paid out starting on July 1, 1987. Parker-Hannifin argued that the claims were incurred as of June 30, 1987 because it was obligated to pay out these benefits under the terms of its collective

199915059

bargaining agreement. The court acknowledged that Parker-Hannifin had a contractual obligation to provide these benefits, but cited the legislative history above in disallowing the entire deduction.

Section 419A(c)(1) provides that the account limit for any qualified asset account is the amount reasonably and actuarially necessary to fund claims incurred but unpaid and administrative costs with respect to such claims. Claims are incurred only when an event, such as a medical expense, actually occurs. A contractual obligation to pay benefits does not satisfy this requirement; see *Parker-Hannifin v. Comm.* Therefore, a fully insured plan has an account limit of zero.

A set-aside may be taken into account only to the extent that it does not result in an amount set aside that is greater than the account limit. Since in your case the account limit is zero, any amount set aside would exceed the account limit. Therefore, such a set-aside is not taken into account in determining your taxable income.

You are not operated pursuant to a collective bargaining agreement. Therefore, the exception of section 419A(f)(5) of the Code does not apply to you.

Based on the foregoing, we rule that your taxable income includes investment income earned on amounts set aside to pay insurance premiums on behalf of employees with "banked" hours.

This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

If you have any questions, please contact the person whose name and telephone number are shown in the head of this letter. We are forwarding a copy of this letter to your key District Director.

Sincerely,

*Gerald V. Sack*

Gerald V. Sack  
Chief, Exempt Organizations  
Technical Branch 4